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The War and Accounting Problems

BY C. H. KNOLL
(New York Office)

Even though we are not involved in the European conflict, there are nevertheless economic factors arising out of it which will have to be dealt with in the examination and presentation of financial statements of companies which have foreign affiliations.

Some of the more important accounting problems which have arisen as a result of the war in Europe are discussed in the following paragraphs.

FLUCTUATIONS IN FOREIGN EXCHANGE

Companies having subsidiaries in foreign countries presently engaged in war are faced with the problem of dealing with extraordinary adjustments arising from translation into U. S. dollars of net current assets of foreign subsidiaries at current rates of exchange. It has been generally accepted practice in the past to translate statements of income of foreign companies (except as to depreciation and other items which require special treatment) at average monthly rates of exchange applied to monthly statements of income, or, in cases where monthly statements were not available, generally to use one of the two bases stated below, depending upon the extent of fluctuations in rates of exchange during the year:

1. To translate at an estimated weighted monthly average rate of exchange in case of wide fluctuation; or

2. To translate at current rate of exchange at end of period where fluctuations were relatively minor throughout the year.

After translating (a) the net current assets of foreign companies at current rates of exchange, and (b) the noncurrent assets and liabilities and the capital, at rates of exchange prevailing at dates of acquisition or commitment, the fluctuation in foreign exchange during the period is usually found by difference. For example, if the difference between opening and closing surplus is $1,000,000; and the net changes during the year, representing net income, dividends paid and surplus adjustments, amount to

$800,000; the difference of $200,000 would represent the fluctuation in foreign exchange.

The amount of such fluctuations during the past seven years has been relatively small, and was usually charged or credited in the statement of income to miscellaneous deductions or miscellaneous income. This year, however, especially in cases where companies have large holdings in foreign countries, the year end adjustment for such fluctuations in foreign exchange will be an important item in the statement of income. Undoubtedly there will be many cases where foreign subsidiaries will report net income in foreign currencies but when their financial statements are translated into U. S. dollars there will be a large loss, such loss of course being occasioned largely by the translation at current depreciated rates of exchange of the net current assets of the foreign company at the end of the year.

In cases where fluctuations in foreign exchange are material in amount it would seem advisable to reflect the operating results in the consolidated statement of income before and after deduction of this item. Whether or not foreign exchange rates will rise in the near future to a point equivalent with rates prevailing six months or a year ago, is a matter of conjecture at this time. There seems to be no sound reason why cash, accounts receivable and inventories of a foreign company should be valued on a basis different from the conventional method of cost or market, whichever is lower, which is applied to similar assets located in this country. Certainly there would be no doubt that a write-down of inventories in this country from cost to market should be charged to income and not to earned surplus. If prevailing exchange rates were not applied to current assets of foreign subsidiaries such practice would in effect constitute a failure to recognize a shrinkage in market to below cost.

Of course, if exchange rates recover next year, income may be credited with the amount of such appreciation in the dollar value of net current assets in foreign countries. The amount credited to income, however, should not exceed the charge for fluctuation in foreign exchange made to income in the prior year unless the excess is minor in amount.

Accounting Research Bulletin No. 4, issued in December, 1939, by the Committee on Accounting Procedure of the American Institute of Accountants, states the following with respect to losses and gains on foreign exchange:

> Realized losses or gains on foreign exchange should be charged against or credited to operations.
>
> Provision for declines in conversion value of foreign net current and working assets should be made and shown separately.
>
> In considering whether such a provision should or should not be deducted in arriving at the amount of net income for

the year from which the net income per share is ordinarily computed, it must not be overlooked that, if the amount of the provision is relatively large, the balance shown before making the deduction, the deduction itself, and the balance after making the deduction are all significant. It is desirable that investors should consider the component elements of net income and surplus changes and should be given reasonable information to enable them to do so, and that they should not be encouraged to attach undue importance to a single figure.

Where a corporation publishes a continuous statement of income and surplus, the situation can be met by showing the income before and after the deduction of the provision and refraining from describing either figure as "Net Income for the Year" without amplification of the expression.

Where the corporation's practice is to carry the balance of income to a separate surplus statement, either (1) the provision should appear as a charge in the income statement, the balance before and after the charge perhaps being shown, or (2) if the amount and the circumstances are such that this would seriously impair the value of the income statement as an indication of earning capacity, and the charge for that reason is made to surplus, a clear disclosure of the treatment should appear in a note in the income statement.

Restrictions Upon Transfer of Funds

Where a subsidiary company is located in a foreign country having restrictions upon the transfer of funds to this country, the question again arises as to the advisability of consolidating the financial statements of such a foreign subsidiary with those of the United States companies. While the question of restriction upon transfer of funds from foreign countries does not present a new problem, the extent and severity of restrictions this year brought about by the war in Europe no doubt will warrant further study and new considerations as to treatment in financial statements of assets located in foreign countries. Of course the exclusion from consolidation of such financial statements this year would destroy comparisons with prior years' consolidated financial statements.

The theory of consolidated financial statements is to present the position and results of operations of a group of companies as though they constituted a single entity. Upon this theory all subsidiary corporations are looked upon as branches of the parent company. It would be unthinkable to attempt to present the position of a company having, say, ten operating branches without combining in the financial statement all the assets and liabilities of each of the branches with the assets and liabilities shown on the books of the head office.

The omission of the financial statements of a foreign subsidiary from consolidated financial statements involves, in effect, the same limitation as was cited above in respect of branches. Even in cases where separate financial statements of foreign subsidiaries are submitted in support of the investments in such companies, there may be intercompany profits and adjust-

ments which, if not adequately disclosed or provided for in the financial statements, will render them misleading on an unconsolidated basis.

In view of the varied situations which might be present in individual cases, it seems futile to attempt to lay down a rigid rule to be followed with respect to consolidating financial statements of foreign subsidiaries. For example, if a parent company sells products to a foreign subsidiary at a profit and the foreign subsidiary operates at a loss, the exclusion of the financial statements of the foreign subsidiary from the consolidated statements would result in an overstatement of income of the parent company. In a situation such as this, it would seem desirable to consolidate the financial statements of the foreign subsidiary even though located in a country having restrictions upon transfer of funds to this country. However, if the foreign subsidiary's statements are not consolidated, adequate reserves should be provided on the books of the parent company to offset intercompany profits and to provide for losses of the subsidiary.*

There also may be situations with respect to subsidiaries located in China, Czechoslovakia, Poland, and other countries in a similar category, the financial statements of which definitely should not be consolidated. Depending upon information available, it may be necessary to provide substantial reserves or to write off the entire amount of investments in such foreign companies. Such charges, in my opinion, should be made against consolidated income for the year and the portion of losses not applicable to current operations of the subsidiary should be shown as a separate item.

In order to overcome objections with respect to consolidating financial statements of foreign subsidiaries located in foreign countries having restrictions upon transfer of funds to this country, one of the two methods stated below is suggested as a means of dealing with the situation:

1. Consolidated financial statements might be prepared to show assets and liabilities of foreign subsidiaries located in countries having restrictions upon transfer of funds distinct from assets and liabilities of domestic companies and foreign companies located in countries where there are no such restrictions. This could be done by a three column arrangement showing appropriate captions for said foreign and domestic companies and consolidated totals. If it were deemed desirable, a fourth column could be added so that two columns might be devoted to foreign companies to show them in the two categories mentioned.

2. The financial statements of all foreign subsidiaries might be consolidated with domestic companies in the usual manner and appropriate notes made to the

* See also Accounting Research Bulletin No. 4 issued by the Committee on Accounting Procedure of the American Institute of Accountants for four alternative methods of disclosure of foreign investments.—Ed.

consolidated balance sheet and related consolidated statement of income, setting forth the amounts of current and non-current assets and liabilities, and surplus and of income and expenses, respectively, included for foreign companies located in countries having restrictions upon transfer of funds to this country.

Lack of Current Financial Statements

Due to war conditions in certain countries it may be impossible to obtain financial statements in time for inclusion in consolidated reports to stockholders or in annual reports which must be filed with the Securities and Exchange Commission under the provisions of the Securities Exchange Act of 1934. Since in such cases it will be impossible to consolidate, it may be desirable to carry the investments in such foreign companies in the consolidated or parent company balance sheets (a) at cost, with a parenthetical notation as to the amount of underlying net assets based on information obtainable from the most recent balance sheets available, if such amount is greater than cost, or (b) at an amount which will reflect the shrinkage below cost of the underlying net assets of the foreign companies, based on current exchange rates applied to assets shown on the most recent balance sheets available, with a parenthetical notation as to cost. If holdings in foreign countries represent an important part of the total consolidated assets of a group of companies, it would appear desirable to support the amount at which investments in such companies are carried in the parent company's balance sheet, by submitting the most recent available financial statements of foreign companies translated on the basis of current exchange rates.

General Rule 10 in the Instruction Book for Form 10-K, and similar rules applying to other forms required to be filed under the provisions of the 1934 Act, provide for delays in furnishing information beyond the date upon which annual reports must be filed with the Securities and Exchange Commission, and for the omission of material which is neither known nor available.

Confirmation of Assets in Foreign Countries

When a request for confirmation is mailed to a customer in the United States and it is not returned to the auditor by the post office, he is entitled to feel reasonably assured that the confirmation request was properly delivered. Under present conditions, he cannot feel the same assurance as to requests for confirmation mailed to foreign countries. The "positive form" of confirmation request is customarily used for such items as cash and it may well be that the auditor may not receive a reply to such "positive form" of request due to the fact that the request has not been delivered. In view of this situation, it may be desirable in cases where receivables or other assets are ma-

terial in amount and are located in foreign countries, to use the "positive form" of request. In case replies are not received to the "positive form" of request concerning assets located in foreign countries the auditor will, of course, give consideration to whether the amounts involved are sufficiently material so that he should state in his report that replies to such "positive form" of request have not been received and make any exception or qualification which he may believe should be made under the particular circumstances.

Rise in Commodity Prices

We have already experienced a rise in some commodity prices which, in view of the repeal of the arms embargo, may become more extensive if the war in Europe is carried on for any considerable length of time. Here consideration may well be given to the provisions of the Revenue Act of 1939 which make it possible for companies to adopt for tax purposes the costing of inventories on the "last-in, first-out" basis. Managements of corporations have been reluctant in the past to adopt this basis of costing inventories for general accounting purposes, because of the difficulty and expense which would have been occasioned in keeping books on two bases, namely, for tax and general accounting purposes. In view of the modification of the tax law, a number of corporations dealing in or manufacturing products involving commodities which are subject to wide fluctuations in price have already adopted the "last-in, first-out" method of costing.

The general adoption of this method by all corporations similarly affected seems timely in view of present conditions. This method should tend to avoid the piling up of undistributable profits in inventories as was the case during the 1917-1921 era. Companies which avail themselves of the advantages of the "last-in, first-out" method thus will avert to a considerable extent large write-downs of inventories when prices tumble from their peaks to lower levels.

War Contracts and Increased Plant Facilities

Certified public accountants undoubtedly will be called upon to aid in solving problems relating to costs in connection with cost-plus contracts and special situations arising from contracts between domestic companies and foreign countries presently engaged in war. The recent move on the part of the United States Government to enlarge the Army and Navy forces has brought about increased activities for domestic companies through contracts awarded for additional supplies and equipment. This brings to mind such questions as allocation of overhead, accelerated depreciation, amortization of excess

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Excess Profit on Vinson Act Contracts

By H. E. Bischoff
(*New York Office*)

The Act of March 27, 1934 (48 Stat. L. 505; 34 U.S.C. 496; Internal Revenue Code Sections 650 and 651), commonly referred to as the Vinson Act or Vinson-Trammell Act, as originally enacted, provided under Section 3 for the payment into the Treasury of any profit in excess of 10 per cent of the contract price of each separate contract or subcontract for the construction and/or manufacture of any complete *naval vessel* or *naval aircraft* or any portion thereof in an amount in excess of $10,000.* It also provided that "if such amount is not voluntarily paid the Secretary of the Treasury may collect the same under the usual methods employed under the internal revenue laws to collect Federal income taxes."

The Act was amended June 25, 1936, to provide that where a loss was sustained by a contractor, within an income-taxable year, on *all* such contracts, such loss shall be allowed as a credit in determining the total excess profit on *all* such contracts for the next year. Through this amendment the inequity of holding a contractor liable for the entire excess profit on one contract when he had sustained a loss on another similar contract completed in the same period was cured.

The part of the amendment which referred to the carrying forward of losses has been held by the Treasury to apply to contracts completed in income-taxable years beginning after December 31, 1935 (T. D. 4723; C. B. 1937-1, 519).

The amendment of June 25, 1936, further provided that "this section shall not apply to contracts or subcontracts for scientific equipment used for communication, target detection, navigation and fire control. . . ."

In other words, there is no limitation on the profit which may be earned on this class of contracts or subcontracts.

A further and more far-reaching amendment was enacted April 3, 1939 (Public No. 18, 76th Cong.). The limitation upon contractors' profits on *naval vessels* affected by the Act remained at 10 per cent, but the limit on *naval aircraft* contracts was extended to 12 per cent of the contract price. Also by Sec. 14 of the Act of April 3, 1939 (National Defense Act) the provisions of Sec. 3 of the Act of March 27, 1934 as

* For a somewhat similar act limiting profits on contracts for the construction of *merchant* vessels, see the Merchant Marine Act of 1936 and regulations promulgated thereunder.

amended were made to apply for the first time to *army aircraft* contracts, the profit on which was limited to 12 per cent of the contract price. As to *aircraft* contracts only (whether for Army or Navy), the Act as amended permits the carrying forward of losses or deficiencies in profit as credits in determining the excess profit on all such contracts for the next succeeding four income-taxable years.

Treasury Regulations

Regulations interpreting the Vinson Act as amended by the Act of April 3, 1939, affecting Navy contracts completed in taxable years ending after April 3, 1939 and Army contracts entered into after April 3, 1939, were promulgated by Treasury Decisions 4906 and 4909 with reference to Navy contracts and Army aircraft contracts, respectively (I.R.B. 1939-27). Those regulations are made the basis of this article. As to Navy contracts completed prior to the first taxable year ending after April 3, 1939, the reader is referred to T.D. 4723 as amended by T.D.'s 4741, 4861 and 4897.

While the Act does not use the word tax, it nevertheless provides that the excess profit shall be determined by the Treasury Department and if not voluntarily paid into the Treasury may be assessed and collected by the same methods as in the case of the income tax.

Computation of Excess Profit

The first step is to ascertain the total contract prices of all contracts or subcontracts completed within the taxable year. The Treasury has ruled in I.T. 3275 (C.B. 1939-1,403) that "The term 'completion of the contract' . . . means the date of delivery of the vessel, aircraft or portion thereof covered by the contract or subcontract, even though the contract contains a clause providing that for the purpose of the Act the contract shall be considered complete upon final payment." There has as yet been no court decision to indicate whether or not this interpretation by the Treasury is sound.

The second step is to ascertain the costs of performing such contracts, and to deduct such costs from the total contract prices of such contracts. The amount remaining is the amount of net profit or net loss upon such contracts completed within the taxable year.

In case of a net profit there is then to be subtracted therefrom: (1) 10 per cent of the total contract price as to contracts for naval *vessels,* or 12 per cent as to contracts for navy or army *aircraft;* (2) the amount of any net loss sustained in the preceding year in respect of contracts for naval *vessels;* and (3) in respect of naval or army *aircraft* contracts, the unused portion of any net loss and/or deficiency in profit in a prior year. Each group of vessel or aircraft

contracts is to be treated separately and not combined for the purpose of subtracting losses.

The term "deficiency in profit," applying only to aircraft contracts, is defined as the amount by which 12 per cent of the total contract prices of all aircraft contracts completed within an income-taxable year ending after April 3, 1939 exceeds the net profit upon such contracts.

There is then deducted from the remaining profit, as determined above, the Federal income tax paid or to be paid on such profit. The balance remaining is the excess profit to be paid to the United States by the contracting party for the taxable year in which the contract is completed.

Illustrative Computation

The following example of the method of determining liability for excess profit on contracts for naval *aircraft* where contracts for naval *vessels* are also entered into with the same contractor is taken from T.D. 4906:

On September 1, 1939 the B Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, entered into a contract with the Secretary of the Navy for the construction of aircraft coming within the scope of the Act, the total contract price of which was $200,000. On March 10, 1940 the B Corporation entered into another such contract, the total contract price of which was $40,000. Both contracts were completed within the calendar year 1940, the first at a cost of $155,000 and the second at a cost of $45,000. During the year 1940 the B Corporation also completed at a loss of $10,000 two contracts entered into for the construction or manufacture of portions of a naval vessel coming within the scope of the Act.

For the year 1939 the B Corporation sustained a net loss of $2,500 and a deficiency in profit of $1,000 on all contracts and subcontracts for naval aircraft coming within the scope of the Act and completed within the calendar year 1939. For the year 1939 the B Corporation also sustained a net loss of $1,800 on all other contracts and subcontracts coming within the scope of the Act which were completed within the calendar year 1939.

For purposes of the Federal income tax, the net income of the B Corporation for the year 1940 amounted to $96,000, which amount included the net profit of $40,000 upon the contracts entered into on September 1, 1939 and March 10, 1940. For the year 1940 the B Corporation paid Federal income taxes amounting to $19,200.

The excess profit liability of the B Corporation for 1940 is payable with respect to the contracts for naval aircraft which were completed in 1940. The loss of $10,000 on other contracts completed in 1940 and the net loss of $1,800 for 1939 on contracts and subcontracts other than for naval aircraft do not enter into the computation of such liability. Accordingly, the excess profit liability of the B Corporation for 1940 is $6,700 computed as follows:

Total contract prices		
Contract No. 1	$200,000	
Contract No. 2	40,000	$240,000
Less: Cost of performing contracts		
Contract No. 1	$155,000	
Contract No. 2	45,000	200,000
Net profit on contracts		$40,000

Less: 12 per cent of total contract prices (12 per cent of $240,-000)	$28,800	
Net loss from 1939	2,500	
Deficiency in profit from 1939	1,000	32,300
Excess profit for year 1940		$7,700
Less: Credit for Federal income taxes (Federal income tax on $7,700 at rates for 1940)		$1,000*
Amount of excess profit payable to the United States		$6,700

Net Loss and/or Deficiency in Profit

The following example, also taken from T.D. 4906, illustrates the method of claiming credits for net loss and deficiency in profit in computing excess profit in the case of aircraft contracts:

For the calendar year 1939 the B Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, sustained a net loss of $10,000 and a deficiency in profit of $35,000 upon all contracts and subcontracts for naval aircraft and portions thereof coming within the scope of the Act and completed within that year. On all contracts and subcontracts for naval aircraft coming within the scope and completed within the calendar year 1940 the B Corporation realized a net profit which was $25,000 in excess of 12 per cent of the total contract prices of such contracts and subcontracts. On all contracts and subcontracts for naval aircraft coming within the scope of the Act and completed within the calendar year 1941 the B Corporation realized a net profit which was $20,000 in excess of 12 per cent of the total contract prices of such contracts.

The net loss of $10,000 and deficiency in profit of $35,000 (or a total of $45,000) sustained in 1939 with respect to contracts and subcontracts for naval aircraft completed within that year may be taken as a credit to the extent of $25,000 in computing the excess profit on the contracts and subcontracts for naval aircraft completed in 1940. The remainder of such net loss and such deficiency in profit ($45,000 minus $25,000 or $20,000) may be taken as a credit in computing the excess profit realized on the contracts and subcontracts for naval aircraft completed in the year 1941.

Computation of Cost

In order to complete the reports required the contractor must keep such records as will enable him to assign to each separate contract the cost of performing such contract.

Both T.D. 4906 and T.D. 4909 set forth in considerable detail the methods of computing contract price, elements of cost, excess profit, etc., which, in the interest of brevity, are not repeated here. The procedure prescribed by the Treasury requires the use of an adequate cost system. In I.T. 3120 (C.B. 1937-2, 593) the Treasury ruled that where the system of account-

* In this example the Treasury has apparently computed the credit for income taxes as in the case of a corporation having only $7,700 of net income. It would seem fairer and more logical to allow a credit of 20% of $7,700, i.e., the ratio of the tax of $19,200 to net income of $96,-000.—*Author.*

ing of the contractor clearly reflects the actual profit derived from the contracts, a separate system of detailed accounts is not necessary.

The contractor's records should show the direct costs, i.e., expenditures for materials, labor and any other direct expenses, attributable to each contract.

Allocation of Indirect Costs

As to the allocation of indirect costs, T.D.'s 4906 and 4909 state that "no general rule applicable to all cases may be stated for ascertaining the proper proportion of the indirect costs to be allocated to the cost of performing a particular contract or subcontract. Such proper proportion depends upon all the facts and circumstances relating to the performance of the particular contract or subcontract."

Bonuses earned for bettering performance and penalties incurred for failure to meet guarantees, as well as trade or other discounts granted by a contractor or subcontractor, are regarded as adjustments of the original contract price.

Items Excluded From Cost

Among the items which the Treasury holds are not allowable as part of the cost of performing a contract are interest on invested capital or other interest incurred or earned; entertainment expenses, donations (with certain exceptions); profits or losses from sales or exchanges of capital assets; extraordinary expenses due to strikes or lockouts; fines and penalties; expenses, maintenance and depreciation of excess facilities vacated or abandoned; increases in reserves for contingencies, repairs, compensation insurance and guarantee work; unreasonable compensation for services; premiums for life insurance on lives of officers; losses on investments and bad debts; and Federal and State income and excess-profits taxes and surtaxes.

Only such experimental and development expenses as pertain to the article being produced under a contract entered into under the Vinson Act constitute an allowable part of the cost of performing the contract (I.T. 2813; C.B. XIII-2, 579). On the other hand, experimental and development expenses which can be shown to be applicable to the article produced under a Vinson contract, even though written off in prior years, are allowable cost items.

Guarantee expenses incurred after delivery, incident to the correction of defects which the contractor is required to make under the guarantee provisions of the contract, are allowable costs but an estimated reserve for such expenses is not.

Credit for Income Taxes

A credit is allowed for the Federal income tax and also the excess-profits tax, if any, imposed upon the excess profit (as computed under the Vinson Act) because of the inclusion of such excess profit in the

Federal income and excess-profits tax return of the contractor for the year in which the contract was completed. Accordingly, if, as a result of a subsequent examination of the income and excess-profits tax return, the tax liability is revised, consideration should be given to the possible effect of such change on the credit allowed in computing the excess profit on Vinson Act contracts.

Since the Treasury allows the credit for Federal income taxes in computing the excess profit on the Vinson Act contract, such excess profit is not an allowable deduction for Federal income tax purposes, otherwise a duplicate deduction would result.

Report to Secretary of War or Navy

Upon completion of a contract the contractor is required to make a report to the Secretary of War or the Navy, stating the total contract price, the cost, the net income and the per cent such income is of the contract price. The contractor must also include in the report a statement showing:

(1) The manner in which the indirect costs were determined and allocated to the cost of performing the contract or subcontract;

(2) The name and address of every subcontractor with whom a subcontract was made, the object of such subcontract, the date when completed and the amount thereof; and

(3) The name and address of each affiliate or other organization, trade or business owned or controlled directly or indirectly by the same interests as those who so own or control the contracting party, together with a statement showing in detail all transactions which were made with such affiliate or other organization, trade or business, and are pertinent to the determination of the excess profit.

The Treasury may be expected to scrutinize carefully any intercompany arrangements made for the purpose of reducing the excess profit.

Form of Subcontract

Recently in I.T. 3338 (I.R.B. 1939-49) the Bureau of Internal Revenue ruled that the form of "agreement" by a subcontractor to be bound by the provisions of Sec. 3 of the Vinson Act, as amended, is not material, but there must be an agreement of record by the subcontractor with the prime contractor (under seal where necessary, as between corporations) showing the amount of the subcontract award and stating that the subcontractor agrees to the provisions of Sec. 3 of the Vinson Act. The Bureau will not object to the use of a rubber stamp, properly authenticated. It is emphasized in this ruling that the question of whether each order received by a subcontractor in an amount not exceeding $10,000 is an actual separate order and not a subdivision of a larger order will be determined upon the facts.

Report to Treasury

For each income-taxable year the

contractor is required to file with the collector of his district an annual report on all contracts coming within the scope of the Act. This report should be in columnar form showing separately for each contract completed in the taxable year the total contract price, the cost, the resulting profit or loss, and a summary showing the excess profit or loss separately for naval *vessels* and navy or army *aircraft*. A copy of the report to the Secretary of War or the Navy for each contract should accompany the report to the Treasury.

The report is due on or before the 15th day of the ninth month following the close of the contractor's income-taxable year.

An extension of time granted for filing the income tax return does not extend the time for filing the Vinson Act report. Applications for extensions of time for filing should be addressed to the Collector of Internal Revenue for the contractor's district, who is authorized to grant extensions.

Payment of the excess profit is to be made to the local Collector. It may be paid in quarterly installments beginning with the 15th day of the ninth month following the close of the income-taxable year.

Under present procedure revenue agents who examine Federal income and excess-profits tax returns are instructed to include in their examination reports on Vinson Act contracts.

The same procedure now followed as to protests against proposed deficiencies for income taxes may be followed with reference to revised excess profit liability on Vinson Act contracts.

The U. S. Board of Tax Appeals in *Foster Wheeler Corporation* v. *Commissioner,* 40 B.T.A. 1, held that "the Board has jurisdiction to redetermine deficiencies in excess profits liability on Navy contracts under section 3 of the Vinson Act."

Closing Agreements

Press Service No. 18-79, released by the Treasury September 18, 1939, with reference to closing agreements between the Treasury and contractors engaged on contracts affected by the Vinson-Trammell Act, reads as follows:

> To assist in the execution of the national defense program, Secretary Morgenthau has developed a formula to facilitate operations under Army or Navy contracts which are subject to the Vinson-Trammell Act. This Act limits contractors' profits on naval vessels to 10 per cent and on military and naval aircraft to 12 per cent of the contract price; the Bureau of Internal Revenue enforces the limitation.
>
> Secretary Morgenthau has informed the Secretary of War and the Acting Secretary of the Navy of his willingness to negotiate closing agreements, which are authorized by section 3760 of the Internal Revenue Code, with contractors who must enlarge their facilities in order to meet Army or Navy needs. These closing agreements, which would be binding on both the Treasury and the contractor, would set forth, in advance of the completion of the contracts, the manner in which the Bureau of Internal Revenue

is to treat the cost of any special facilities in the computation of the contractor's profits under the Vinson-Trammell Act. Normally, in the absence of the closing agreement procedure, the cost of new facilities may be amortized by depreciation or obsolescence allowances determinable only upon completion of the contract.

The Army or Navy will certify to the Treasury its opinion concerning the proper percentage of cost to be allowed as a deduction. When the Army or Navy certifies to the Treasury that installation of special facilities by a contractor is necessary for the national defense program and that, due to technical considerations, such facilities will be partially or totally useless after completion of the contract, the Treasury, at the time the contract is signed, will agree on the basis of the facts in each particular case to allow a fixed percentage of reasonable cost to be charged when the profits are computed under the Vinson-Trammell Act.

The Treasury, War and Navy departments each has special committees to handle matters under the Vinson-Trammell Act; the three committees meet jointly to consider common problems.

The first closing agreement was recently entered into by the Treasury. Because of its interest for other contractors affected by the Vinson-Trammel Act, Press Service No. 19-53, December 4, 1939, is quoted below:

The Treasury Department, acting under section 3760 of the Internal Revenue Code, has signed a closing agreement with the Colt's Patent Fire Arms Manufacturing Company stipulating how certain items will be handled in computing the company's profit on a War Department contract which is subject to the profit limiting provisions of the Vinson-Trammell Act and the National Defense Act. This is the first closing agreement executed with respect to these Acts.

The closing agreement provides that, for the period of performance of the contract, Colt's may charge off as an indirect factory expense the cost of special tools, jigs, dies, fixtures and gauges which must be acquired by the company to carry out the contract and are useful only for this particular work. Before making the closing agreement the War Department made certification to the Treasury of the necessity for such tools, jigs, etc., and is also to certify to the Treasury the amount of such tools, jigs, etc., so acquired and used. Although there is no present expectation that the special equipment will be used except on this contract, in order to protect the Government against any unforeseen future contingencies, the closing agreement provides that, if these special tools, jigs, etc., are used on work other than for the Government, an allocable portion of their cost shall be charged against the other work and the deduction allowed for profit limitation purposes shall be reduced accordingly.

As to certain additional standard machinery, other than the special tools, etc., which Colt's must install to perform the contract, the closing agreement provides that the company will be permitted to charge off 10 per cent of the cost each year as a depreciation allowance. This portion of the closing agreement contains an additional proviso stating that, if upon completion of the contract the fair market value of such standard machinery is less than one-half of the reasonable cost of the machinery, the company will be allowed a further deduction equal to the difference between the fair market value and one-half such cost. The deductions allowed with respect to such standard machinery are not permitted to be treated as direct charges against the contract but are to be prorated to all work on which the machinery is used.

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The purpose of this journal is to communicate to every member of the staff and office plans and accomplishments of the firm; to provide a medium for the exchange of suggestions and ideas for improvement; to encourage and maintain a proper spirit of cooperation and interest, and to help in the solution of common problems.

Don S. Griffith

It is a pleasure to announce to those members of the L. R. B. & M. organization who may not yet have heard the news informally that Mr. Don S. Griffith has become a member of our firm.

Mr. Griffith originally came to us at our San Francisco office. Toward the close of 1925 he was placed in charge of the Seattle office and has carried that responsibility ever since. The office has grown during this period and Mr. Griffith is highly esteemed by clients of the firm in the Northwest.

He holds the C. P. A. certificate of the State of Washington and is at the present time a member of the Board of C. P. A. Examiners in that State. He is also a member of the American Institute of Accountants and of the Washington Society of Certified Public Accountants,

which latter organization he has served in various capacities including that of President.

Undistributed Profits Tax

During December *The New York Sun* presented a long article from its Washington correspondent, Phelps Adams, entitled "Treasury Rule on Profits Tax Causes Storm." In substance it indicated an irate feeling in Washington that the Treasury was endeavoring through the use of Section 102 of the Internal Revenue Code, and by the issuance of Treasury Decision 4914 (promulgated during 1939), to secure in effect the results intended by the ill-fated undistributed profits tax.

One paragraph of *The Sun's* article read as follows:

> The Treasury regulations which are causing all the trouble, it was learned today, were issued at the behest of the President and his little band of New Deal reformers who were responsible in the first instance for the passage of the undistributed profits tax, and who are now determined, it appears, to intimidate business into observing the principles underlying that tax, although it has since been repealed.

Regardless, however, whether or not *The Sun's* correspondent was correctly informed as to the motives which underlay the issuance of Treasury Decision 4914, it behooves taxpayers and their advisers to be fully aware of their rights and of the principles on which we believe the administration of Section 102 must rest.

We suggest, therefore, to our staff a rereading of the leading article in the November, 1939, issue of the L. R. B. & M. JOURNAL. Corporate taxpayers following the principles enunciated therein, and (when they have profits) paying dividends in accordance with good business judgment rather than because of an assumed threat from T. D. 4914, should have no fear of being subject to the penalty tax.

Two Decades

It is with a feeling of almost incredulity that the editor writes Volume 21, No. 1, on the first page of this issue of the L. R. B. & M. JOURNAL. It hardly seems possible that it is now twenty years since the JOURNAL came into being for the purpose indicated at its masthead. During those years the JOURNAL has brought a variety of material to the L. R. B. & M. organization, some of it technical, some of it suggestive for improvement of practice —an aim always to be had in mind —some of it historical, personal and at times even amusing. In other words, it has sought to make at least a fragmentary record of those developments over the years that would be of particular interest to the members of our organization and occasionally to the wider circle of our clients. The special tax issues, for example, have served both our staff and our clients.

It has also been our sad duty during those years to record the passing on of some who had labored long and effectively with us in developing the L. R. B. & M. organization and in serving the interest of our clients, not only in this country but also in Europe.

We believe the JOURNAL has been one indication of an L. R. B. & M. spirit which has grown over the years, and which causes everyone forming a part of the organization to take a keen interest in performing his share of its work in the most effective way and in maintaining the high ideals which its founders and those who have joined them throughout the years have ever sought to uphold.

Sometime ago we mentioned, as a matter of passing interest to our readers, that although we maintain no subscription or extended mailing list for the JOURNAL, we have received requests for it from all parts of the world, so that at the present time there are schools, colleges, libraries and other organizations receiving copies of the JOURNAL, pursuant to their request, situated as far apart as China and the Philippines in the Orient, Australia in the Antipodes, Europe, and Central and South America in the Occident.

It is our hope that the JOURNAL will, in coming years, have many events to record of importance and interest to the L. R. B. & M. organization.

Opportunities in America

The November 1937 issue of the L. R. B. & M. JOURNAL contained a brief article which emphasized the opportunities for advancement to the young man starting in a humble position in America, as indicated by a list of the first jobs and initial pay of the presidents of the companies included in the Bell Telephone System.

More recently, it has been announced that the new head of the Western Electric Company, Mr. Clarence G. Stoll, began his connection with the company in 1903 and was a student apprentice at the company's shops at Chicago after having been graduated from Pennsylvania State College. His initial salary was $10 per week.

The retiring president, Mr. Edgar S. Bloom, joined the company in 1896 after graduating from the University of Pennsylvania. His first employment was as a $12 a week traffic inspector with the Metropolitan Telephone and Telegraph Company, predecessor of the New York Telephone Company.

Another indication which has come to us in recent weeks of a similar accomplishment in "making good" on opportunity in America is the announcement that it is just fifty years since two young M. I. T. graduates hung out their shingle as consulting electrical engineers. As expressed in the announcement, "at the dawn of the electrical age,

Charles A. Stone and Edwin S. Webster were taking electricity out of the laboratory and putting it to work. Theirs was a pioneer partnership." From this modest beginning has grown the outstanding national organization of Stone & Webster, Incorporated, of which Mr. Stone is Chairman and Mr. Webster is Vice Chairman. Their accomplishments in engineering and construction for all types of industry and the supervision of electricity, gas and transportation projects are well known. We have a keen satisfaction in numbering an organization of such high standing among our clients and express both our congratulations and our good wishes for still further accomplishments in the years ahead.

One of those who have announced themselves as candidates for the presidential nomination has recently sounded a very timely note in suggesting that we drop the note of defeatism which views America as having reached the maturity of its development and offering but little opportunity for the young man of today. We believe there is much fundamental truth in the old adage that "there are as good fish in the sea as have ever been caught."

Northern Lights

By James F. Egan
(San Francisco Office)

Dear Oscar:

I'm just recovering from that Mexican trip (you remember, the chile beans) when in comes Fred Breslin to tell me I'm going to the Arctic Circle for one of our clients who is in the gold dredging business around those parts.

And so it came to pass that shortly thereafter I found myself sailing out of Seattle in a northerly direction bound for the land of the sourdough and the malamute, accompanied by the client's general auditor, Frank Benson.

Great steamer trip, Oscar, that one to Alaska on the inside passage. All you have to do is eat and sleep, and play a bit of cribbage and shuffleboard for about four days, when you find yourself in Juneau, the capital of Alaska. En route we stopped at Ketchikan and Wrangell, a couple of small places which exist on fish canneries and tourists.

At Juneau we embarked on an airplane for Fairbanks, and what a sensation, Oscar, to fly over those mountains and glaciers! The flight to Fairbanks took about five hours. Too bad it didn't last longer.

Fairbanks is a city of some three to five thousand population, depending upon the season. Our client conducts gold dredging operations within a radius of thirty miles from town. They have six dredges operating on various creeks. Gold dredging on a large scale requires considerable capital. The gold-bearing gravel is covered with from 100 to 140 feet of overburden (muck) which must be washed away by strong streams of water. This is called stripping. Stripping is done from two to four years in advance of dredging so that the dredging will not be interrupted in the event of water shortage.

The gold-bearing gravel is frozen solid and must be thawed before it can be dredged. Thawing is accomplished by driving water pipes equipped with chisel bits down through the gravel to bedrock and forcing cold water down the pipes under pressure. The cold water gradually rises to the surface and thaws the gravel so that it can be dredged.

A dredge is a combination excavating and separating plant which separates the gold from the gravel. This separating process is facilitated by the use of gold recovery tables treated with quicksilver and equipped with cross bars called riffles. The gold amalgamates with the quicksilver, while the earth and water flow off into the dredge pond.

Water is supplied for these operations through a ditch ninety

miles long. The dredges are electrically operated, receiving their power from the company's power plant in Fairbanks.

Fairbanks has a pretty fair baseball team. While we were there we watched a three-game series between Fairbanks and Anchorage, the latter winning the first and third games for the series. The scores were all close.

After we finished our work at Fairbanks we took a plane to Nome, where the company operates three dredges within five miles of the city.

Nome is situated on the Bering Sea and is farther west than Honolulu. It has a population of about a thousand people, half white and half Eskimo. About 100 of the Eskimos live on King Island (90 miles out in Bering Sea) in the winter, where they hunt walrus, seals, and polar bears. In spring they come in large canoes to Nome, where they set up tents and carve the ivory they collected during the winter. They trade their ivory carvings to the stores, mostly for gumdrops, which they like very much.

The Eskimos live principally on dried fish which they first dip in seal oil. They call the seal oil "big stink" and, believe me, Oscar, I think they have the right word for it.

I was particularly attracted by the big malamute dogs around Nome. They are called huskies. These dogs do nothing all summer but eat blubber and howl at night. They point their noses straight up at the moon and emit a long mournful howl that you might take for the cry of a lost soul. I got pretty chummy with a big pooch that lived near us. I used to bring him bones and meat from the restaurant where we took our meals. After the second day he began to look for me. I called him Louie.

Father Hubbard, the glacier priest, was in Nome when we were there. I had several interesting conversations with him.

I returned to Fairbanks with Frank Benson and left him there, then proceeded back to San Francisco. I hope to see Frank again as he is a bit of all right.

Your old pal,

Jimmy Egan

Notes

Mr. John V. Chambers of our Los Angeles staff, who recently received the C.P.A. certificate from the State of California, was awarded the John F. Forbes medal for receiving the highest grade of the four hundred and forty-one candidates who sat for the C.P.A. examination of November, 1938 and May, 1939 in that state. We extend to him our cordial congratulations on his receipt of this honor.

Members of the L. R. B. & M. organization at Detroit are active in quite a number of lines, including teaching and speaking, as indicated by the following:

Mr. Russell recently addressed the Michigan Association of Credit Men at Lansing on "Recent Developments in Audit Procedure"; he also addressed the graduating class of the Walsh Institute of Accounting and participated in leading the round table discussion on Audit Procedure at the Michigan Conference on Accounting held at the University of Michigan, Ann Arbor, Michigan.

Mr. M. A. Yockey has been appointed Chairman of the National Legislative Committee of the Detroit Board of Commerce.

Mr. McCullough recently addressed the Kiwanis Club of Mt. Pleasant, Michigan, on the subject of "Federal Income Taxes as Applied to the Oil Industry."

Mr. E. J. Barr is Chairman of the Education Committee of the Michigan Association of Certified Public Accountants, which Committee has just completed a series of bi-weekly meetings at Wayne University for the discussion of auditing principles for staff members of accounting offices in Detroit. He is teaching a C. P. A. review course at the Walsh Institute of Accounting. Mr. Barr is also Director of Member Attendance in the Detroit Chapter of the National Association of Cost Accountants.

Mr. H. G. Huffmon and Mr. H. M. Woehrle are each teaching courses in Advance Accounting at the Detroit Institute of Technology.

The following are taken from the November 15, 1939 issue of the N. A. C. A. Bulletin:

Boston Chapter

The second technical session of the year was an outstanding one. A very large audience came to hear Past National President Bill Marsh of Pittsburgh talk on "Standard Costs and Budgets—How Do They Control?" Mr. Marsh delivered a thought-provoking talk based upon his wide experience. He gave particular emphasis to the idea that standards and budgets do not, themselves, control, but rather their use provides information which serves as the basis for control by the management which uses them.

York Chapter

The second meeting of the year was held on October 18 at the West York Inn. We were honored in having as our speaker, William F. Marsh, Partner of Lybrand, Ross Bros. & Montgomery, Pittsburgh, who gave us a very interesting and timely talk on inventories.

Mr. Fred C. Dennis, manager of our Cincinnati office, led the discussion from the viewpoint of the accountants in a joint meeting of the Cincinnati Chapter of the Ohio Society of Certified Public Accountants with the Bankers Group of the Cincinnati Association of Credit Men. He has since accepted the chairmanship of the accountants committee which will cooperate with a similar committee of the Bankers Group of Credit Men on matters of joint interest.

Members of our firm are serving on the following committees of the American Institute of Accountants during the current Institute year:

Education, Mr. Ross
Executive, Colonel Montgomery
Accounting Procedure, Mr. Staub
Cooperation with Securities and Exchange Commission, Mr. Sweet (Chairman)
Cooperation with Stock Exchanges, and Natural Business Year, Mr. Sinclair
Inventories, Mr. Lenhart
Auditing Procedure, Mr. Schaffer

Mr. Lenhart is also serving as a member of the Institute's Board of Examiners.

Mr. E. E. Wakefield read a paper at a tax conference of the Massachusetts Society of Certified Public Accountants on December 6 on the subject "Miscellaneous Questions as to the Taxes of Both Individuals and Corporations."

At the November meeting on taxation of The New York State Society of Certified Public Accountants, Mr. N. B. Bergman, of the tax department of the New York office, presented a paper on "Federal Tax Procedural Questions, Decentralization, etc." His paper has been published in the December 1939 issue of the Society's organ, *The New York Certified Public Accountant.*

Mr. A. R. Kassander, of our New York staff, addressed the Scranton Chapter of the National Association of Cost Accountants on December 11 at a dinner meeting. The subject of the address was Installation of an Operating Budget for an Average Concern. On December 13, he served as chairman at the round table session devoted by The New York State Society of Certified Public Accountants to the consideration of Corroboration of Inventory Quantities

by Physical Tests. At this roundtable session, Mr. G. R. Byrne, also of our New York staff, read the principal paper.

Mr. Robert S. Warner addressed a meeting of the St. Louis Chapter of the Missouri Society of Certified Public Accountants, his subject being "Some Practical Aspects of Physical Tests of Inventories." Mr. Warner has been selected as chairman of the St. Louis group of the newly formed Committee on Public Relations of the State Society.

Mr. Mark E. Richardson of our Philadelphia staff spoke before the Philadelphia Chapter of the Association of Bank Auditors and Controllers on December 12 on the subject "Federal and State Taxes on Banks."

The November 1939 issue of *The New York Certified Public Accountant* contained an article on "Gifts to Institutions" by Leonard W. Fageant of our New York staff.

Messrs. Paul Halloran and W. P. Crouch recently passed the Kentucky C.P.A. examinations.

Quite a number of the members of the staff of the New York office are serving on technical committees of the New York State Society of Certified Public Accountants for the year 1939-1940, as will be noted from the following list:

Accountants' Office Procedure
Raymond G. Ankers

Automobile Dealers' Accounting
Edward G. Carson

Cost Accounting
Arno R. Kassander, Vice Chairman

Federal Taxation
Nathaniel B. Bergman

Fiduciary Accounting
John R. Jacobsen

Foreign Trade Accounting
Alvin R. Jennings

Inventory Methods
Arno R. Kassander, Chairman

Investment Trusts
Thomas J. Cogan

Mining and Smelting Accounting
Edward G. Carson

Real Estate Accounting
Ralph F. Grover

Retail Accounting
Edward J. Taylor

State Taxation
Harold E. Bischoff

Mr. William J. Smith has been admitted to membership, and Mr. Alvin R. Almquist has been advanced from associate membership to membership in the New York State Society of Certified Public Accountants. Mr. Robert H. Schlereth has been admitted as an associate of the American Institute of Accountants.

Mr. Haas attended the third National Accounting Conference of the Edison Electric Institute held at the Edgewater Beach Hotel at Chicago November 13, 14 and 15, 1939.

Mr. Staub attended the sessions of the American Accounting Association, held in Philadelphia on December 28 last, which were devoted to consideration of Accounting Research and Federal Accounting.

The War and Accounting Problems

[*Continued from page 6*]

plant facilities, excess profit required under the Vinson Act to be repaid into the National Treasury, etc. The accounting profession rendered numerous and varied services during and after the World War in aiding industry and governmental bodies to work out complicated and unusual problems. The profession stands ready with a backlog of experience and precedents to render again similar services.

Excess Profit on Vinson Act Contracts

[*Continud from page 14*]

The second closing agreement entered into by the Treasury with the Consolidated Aircraft Corporation covering the treatment of tools, demolition of buildings, and abandonment of special facilities and new construction was released December 20, 1939 as Press Service No. 19-74.

It may be expected that a number of contractors will make application for closing agreements based on special allowances for depreciation of facilities used on Army and Navy contracts in order to ascertain in advance the manner in which the Treasury will measure obsolescence or depreciation of the cost of the facilities in computing excess profit realized under the Vinson-Trammell Act.

Lybrand, Ross Bros. & Montgomery

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Cities	*Addresses*
NEW YORK:	Downtown, 90 Broad Street Uptown, 1 East 44th Street
PHILADELPHIA	Packard Building
CHICAGO	231 South LaSalle Street
BOSTON	80 Federal Street
BALTIMORE	First National Bank Building
WASHINGTON	Investment Building
PITTSBURGH	Union Bank Building
DETROIT	Book Building
CLEVELAND	Midland Building
CINCINNATI	Carew Tower
LOUISVILLE	Heyburn Building
SAINT LOUIS	411 North Seventh Street
ROCKFORD	321 West State Street
ATLANTA	Healey Building
DALLAS	First National Bank Building
HOUSTON	Shell Building
SAN FRANCISCO	2 Pine Street
LOS ANGELES	510 South Spring Street
SEATTLE	Skinner Building

EUROPE

LONDON, ENGLAND	3 St. James's Square, S. W. 1
PARIS, FRANCE	3 Rue des Italiens